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## **U.S. Foreign Tax Creditability for VAT: Another Arrow in the ETIE/E-VAT Quiver**

by Martin B. Tittle

Email: [mbt@martintittle.com](mailto:mbt@martintittle.com)

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# U.S. Foreign Tax Creditability for VAT: Another Arrow in the ETI/E-VAT Quiver

by Martin B. Tittle

*Martin B. Tittle is a graduate of the University of Michigan Law School, specializing in cross-border taxation issues. He is grateful to Reuven S. Avi-Yonah, Mette C. Juul, Walter van der Corput, Gregory P. Lubkin, Petros C. Mavroidis, Lan Cao, Alan Schenk, Mihir A. Desai, and anonymous export industry sources for their interest and counsel. The views expressed and any errors that remain are his alone.*

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Everyone, with the possible exception of a few lone and lonely holdouts, is resigned to the fact that the FSC Repeal and Extraterritorial Income Exclusion Act (ETI)<sup>1</sup> will soon be repealed.<sup>2</sup> Everyone, with few to no holdouts, also is convinced that American businesses still need the quantum of help that ETI and its predecessors gave them.<sup>3</sup> Last year, William M. Thomas, R-California, Chairman of the House Ways and Means Committee, proposed several offsets for ETI repeal,<sup>4</sup> but his proposals drew sharp criticism because, by and large, they would only benefit multinationals, not

U.S.-based businesses.<sup>5</sup> Representatives Charles B. Rangel, D-New York, and Philip M. Crane, R-Illinois, recently have addressed that concern by proposing a 3.5 percent tax break for corporate domestic production.<sup>6</sup> Chairman Thomas also expressed frustration with the continuing tax tensions between the European Union (EU) and the United States, saying that the distinction between direct and indirect taxation was, “in today’s world . . . a distinction without a difference.”<sup>7</sup>

The author agrees with the Chairman’s statement and proposes, as another arrow in the ETI-repeal quiver, creditability of VATs (an indirect tax) against U.S. income tax (a direct tax), capped at an appropriate level.<sup>8</sup> VAT creditability will benefit both U.S.-based businesses and U.S. multinationals. Some of those businesses pay VAT to foreign governments now, either due to the presence of subsidiaries or branches in VAT countries or, in the case of U.S.-based businesses, due to

<sup>1</sup>Pub. L. No. 106-519; 114 Stat. 2423 (2000) (codified at IRC sections 114, 941-943).

<sup>2</sup>See World Trade Organization (WTO), Report of the Appellate Body, *United States — Tax Treatment for “Foreign Sales Corporations” Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/AB/RW (14 Jan. 2002) para. 257 (visited 16 Apr. 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108ABRW.doc> (hereinafter *ETI Appeal*) (recommending that the WTO Dispute Settlement Body require the United States to “bring the ETI measure . . . into conformity with its [WTO] obligations”).

<sup>3</sup>See, e.g., Chuck Gnaedinger, “International Tax Reform? Don’t Hold Your Breath, Conference Participants Suggest,” 2002 WTD 222-2 (18 Nov. 2002) (according to U.S. Treasury Deputy Secretary Kenneth Dam, some U.S. companies will be hurt by ETI repeal); Chuck Gnaedinger, “EU, Business Groups Size Up Thomas’s Corporate Tax Plan,” 2002 WTD 136-2 (16 July 2002) (ETI repeal will “cause a very real hardship for many exporters”).

<sup>4</sup>See American Competitiveness and Corporate Accountability Act of 2002, H.R. 5095, 107th Cong. (2002) (hereinafter Thomas bill); see also *infra* text accompanying notes 46-48.

<sup>5</sup>See, e.g., Charles B. Rangel, “Release From U.S. House Taxwriter Rangel on EU ETI Sanctions List,” 2003 WTD 39-17 (27 Feb. 2003) (revenues from ETI repeal should be used to help U.S.-based businesses); Philip M. Crane and Charles B. Rangel, “House W&M Members Crane, Rangel Article on World Trade,” 2002 WTD 181-36 (18 Sept. 2002) (same); Warren Rojas, “U.S. House Ways and Means Chair Introduces International Tax Bill,” 2002 WTD 134-2 (12 July 2002) (“Other Democrats . . . said the [Thomas] bill would cripple major U.S.-based exporters with limited overseas operations”); Gnaedinger, “EU, Business Groups,” *supra* note 3 (“Fred Murray of the Tax Executives Institute on 12 July noted . . . that the repeal of the ETI Act will cause a very real hardship for many exporters.”); Gary Clyde Hufbauer, “Institute for International Economics Policy Brief on Foreign Sales Corporations,” 2002 WTD 230-18, para. 51 (29 Nov. 2002).

<sup>6</sup>See Philip M. Crane and Charles B. Rangel, “Draft Legislative Language of Crane-Rangel Bill to Repeal U.S. ETI Act,” 2003 WTD 71-27 (14 Apr. 2003).

<sup>7</sup>Chuck Gnaedinger and Natalia Radziejewska, “U.S. Lawmakers Still Divided Over FSC-ETI Remedy,” 2003 WTD 31-1 (14 Feb. 2003). Chairman Thomas is not the only person to come to that conclusion. See *infra* note 111 and accompanying text.

<sup>8</sup>If the cap were merely a percentage of each dollar of VAT, the new credit might be “very similar to an exemption system, i.e., little or no U.S. tax collected on foreign business activity.” E-mail from Gary Hufbauer to Martin B. Tittle (11 May 2003) (on file with the author). To avoid that result, VATs could be credited dollar-for-dollar subject to a limitation on the maximum reduction of any single year’s tax liability.

the structure required for certain international transactions.<sup>9</sup> Further, many more U.S. businesses will be paying VAT very soon. Starting 1 July, Directive 2002/38/EC (E-VAT Directive) will require<sup>10</sup> any business delivering software or other digital e-products to an EU consumer over the Internet to pay VAT on that sale.<sup>11</sup> Creditability is justified because VATs, like income taxes, are sometimes nonshiftable<sup>12</sup> and, therefore, can violate capital export neutrality by lowering the rate of return on investment for activities abroad.<sup>13</sup> Adding a capped foreign tax credit for VATs would relieve double taxation and, at the same time, put Chairman Thomas's insight regarding direct and indirect taxes into practice.

### **VAT creditability will benefit both U.S.-based businesses and U.S. multinationals.**

Part I briefly reviews the FSC/ETI controversy. Part II outlines the E-VAT Directive, concluding that, despite its stated purpose — creating a “level playing field” — the directive places non-EU traders at a serious disadvantage. Part III presents the case for VAT creditability, beginning with the rationale for limiting creditability to income taxes, the applicability

of that rationale to VATs as they are understood today, and the similarity between direct income taxes and indirect VATs. Next, this article states three proposed requirements for VAT creditability, and briefly notes the ability of all U.S. businesses (not just multinationals) to fulfill those requirements and take advantage of the credit. Finally, the proposed credit is analyzed in light of the FSC/ETI decisions and found to be WTO-compliant.

## **I. The FSC/ETI Controversy**

The FSC/ETI dispute between the United States and the European Communities (EC) has been the subject of many articles, and readers wishing a detailed review of the six decisions<sup>14</sup> may either consult the author's Web site<sup>15</sup> or the back issues of their favorite journals.<sup>16</sup> Briefly, Foreign Sales Corporations, or FSCs, were created in 1984<sup>17</sup> in an effort to comply with the finding in the GATT 1981 Understanding that “in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities.”<sup>18</sup> In mid-1998, the

<sup>9</sup>See *infra* notes 121-125 and accompanying text.

<sup>10</sup>Strictly speaking, it will not be the E-VAT Directive that imposes the duty to pay VAT, but rather the acts passed in the 15 EU member states that “transpose” the E-VAT Directive's provisions into national requirements. See Case C-141/00, *Ambulanter Pflegedienst Kugler GmbH v. Finanzamt für Körperschaften I in Berlin*, 2002 E.C.R. I-06833, 2002 WL 31333, Grounds para. 51 (restricting the direct effect of EU directives in a VAT context).

<sup>11</sup>See Council Directive 2002/38/EC of 7 May 2002, 2002 O.J. (L 128) 41 (hereinafter E-VAT Directive). Free online services will not be taxed. See *infra* note 54. According to Stephen Bill, head of the European Commission's VAT unit, the E-VAT Directive only applies to e-products delivered by an “automated service.” Doug Smith, “TCPI Panel Examines EU E-Commerce VAT Directive,” 2003 WTD 48-8 (12 Mar. 2003). Transactions involving a combination of human and automated service will be evaluated on a “case-by-case basis,” with the E-VAT Directive applying when there is “little or no human involvement” and the service is one that “in the absence of information technology does not have viability.” European Commission, “European Commission E-VAT Directive Guidelines,” 2003 WTD 66-19 (7 Apr. 2003).

<sup>12</sup>Liam Ebrill et al., *The Modern VAT* 15 (2001) (“[C]ontrary to the view often held by policymakers, the real burden of [VATs] is not necessarily borne only by consumers. . . . The effective incidence of a VAT, like that of any other tax, is determined not by the formal nature of the tax but by market circumstances, including the elasticity of demand for consumption and the nature of competition between suppliers.”). The nonshiftable of VAT may be particularly transparent in some e-transactions with EU consumers after 1 July. See *infra* note 76 and accompanying text.

<sup>13</sup>See *infra* text accompanying notes 98-104.

<sup>14</sup>Those six decisions are: (1) the 1981 Understanding (*Tax Legislation*, L/5271, BISD 28S/114, 7-8 December 1981), which resolved the EC's pre-FSC, DISC complaint in the GATT; (2) the FSC panel report (WTO, Report of the Panel, *United States — Tax Treatment for “Foreign Sales Corporations,”* WT/DS108/R (8 Oct. 1999) (visited 16 Apr. 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108R.doc> (hereinafter *FSC Panel*)); (3) the FSC appellate body report (WTO, Report of the Appellate Body, *United States — Tax Treatment for “Foreign Sales Corporations,”* WT/DS108/AB/R (24 Feb. 2000) (visited 16 Apr. 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108ABR.doc> (hereinafter *FSC Appeal*)); (4) the ETI Panel Report (WTO, Report of the Panel, *United States — Tax Treatment for “Foreign Sales Corporations” Recourse to Article 21.5 of the DSU by the European Communities,* WT/DS108/RW (20 Aug. 2001) (visited 16 Apr. 2003) (available in seven parts beginning with <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108RW-00.doc> and ending with <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108RW-06.doc> (hereinafter *ETI Panel*)); (5) the *ETI Appeal*, *supra* note 2; and (6) the ETI arbitration decision (WTO, Decision of the Arbitrator, *United States — Tax Treatment for “Foreign Sales Corporations” Recourse to Arbitration by the United States under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement,* WT/DS108/ARB (30 Aug. 2002) (visited 16 Apr. 2003) <http://docsonline.wto.org:80/DDFDocuments/t/WT/DS/108ARB.doc> (hereinafter *Arbitration Decision*)).

<sup>15</sup>See Martin B. Tittle, *The FSC/ETI Controversy*, (visited 3 May 2003) <http://www.martintittle.com>.

<sup>16</sup>For example, Gregory P. Lubkin has written several articles about FSC/ETI in volumes 29-31 of *Tax Management International Journal*.

<sup>17</sup>Deficit Reduction Act of 1984, Pub. L. No. 98-369, sections 801-805, 98 Stat. 494, 985-1003 (codified at IRC sections 921-927).

<sup>18</sup>1981 Understanding, *supra* note 14.

European Community filed a complaint in the WTO alleging the FSC legislation was a prohibited export subsidy.<sup>19</sup> The FSC panel agreed, finding first that the FSC was a subsidy under the Agreement on Subsidies and Countervailing Measures (SCM)<sup>20</sup> article 1 because tax revenue, otherwise due, was forgone,<sup>21</sup> and then that it was an export subsidy prohibited in SCM article 3.1(a). U.S. arguments that the 1981 Understanding and SCM, annex I, footnote 59<sup>22</sup> protected FSC fell on deaf ears.<sup>23</sup>

The United States appealed to the WTO Appellate Body and tried to raise a “double taxation” defense under the last sentence of footnote 59.<sup>24</sup> The Appellate Body declined to address that defense because it had not been raised before the panel,<sup>25</sup> and it affirmed the panel’s decision.<sup>26</sup> On 15 November 2000, then-President Bill Clinton signed the FSC Repeal and Extraterritorial Income Exclusion Act of 2000 (ETI).<sup>27</sup> On 7 December, the European Communities filed another complaint.<sup>28</sup>

The ETI panel, following much the same SCM article 1/article 3 methodology as the FSC panel, determined both that the ETI was a prohibited export subsidy and that the United States had failed to comply with its obligation to withdraw all FSC subsidies.<sup>29</sup> The panel ridiculed a U.S. argument that ETI was not an export subsidy because its benefits could be received by nonexporters, saying that, regardless of how many ways the subsidy could be earned without exporting, U.S.-produced goods *did* have to be

exported.<sup>30</sup> The way to neutralize export-contingency, said the panel, was to “grant the equivalent subsidy also” on goods sold directly into, and for use in, the domestic market.<sup>31</sup> Regarding the U.S.’s footnote-59, avoidance-of-double-taxation argument, the panel decided that footnote-59-compliant measures had to be intended to relieve double taxation,<sup>32</sup> and that ETI did not mesh well enough with U.S. foreign tax credits and tax treaties to show that intent.<sup>33</sup>

**The United States appealed to the WTO Appellate Body and tried to raise a ‘double taxation’ defense under the last sentence of footnote 59.**

The United States appealed the ETI panel’s decision, and the Appellate Body affirmed, using slightly different reasoning on two issues. First, regarding the “tax-otherwise-due,” SCM article 1 benchmark, the Appellate Body used Internal Revenue Code (IRC) sections 1, 11, 61(a), 63(a), 901, and 904, which together set up a regime for taxing all gross income (foreign and domestic), less deductions, and then allowing a credit for foreign taxes paid.<sup>34</sup> Second, it determined that footnote-59 measures needed to address only foreign-source income that was so “linked” to a country where the taxpayer was not a citizen or resident that the income could be taxed by that country under international principles of nonresident taxation.<sup>35</sup> The United States could take no further appeals, and arbitration of the EC’s request for authorization to impose approximately \$4 billion per year in sanctions proved fruitless.<sup>36</sup>

When the arbitrator’s decision was handed down on 30 August 2002, U.S. reaction varied. President Bush already had committed the United States to complying with the ETI Appellate Body decision,<sup>37</sup> so administra-

<sup>19</sup>*FSC Panel*, *supra* note 14, para. 1.3.

<sup>20</sup>Agreement on Subsidies and Countervailing Measures, 15 Apr. 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, Uruguay Round of Multilateral Trade Negotiations[:] Legal Instruments Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations Done at Marrakesh on 15 April 1994, vol. 27 (1994) (visited 16 Apr. 2003) [http://www.wto.org/english/docs\\_e/legal\\_e/24-scm.doc](http://www.wto.org/english/docs_e/legal_e/24-scm.doc).

<sup>21</sup>*FSC Panel*, *supra* note 14, paras. 7.39-7.103. The panel used a “but for” test, first establishing a benchmark for the U.S. tax that would be due in the absence of the FSC measure, and then asking, essentially, whether more tax would have been assessed “but for” the FSC legislation. *Id.* paras. 7.41-7.48.

<sup>22</sup>*Id.* paras. 4.324-4.331, 4.362-4.382, 4.396-4.399, 4.429-4.433, 4.523-4.542, 4.672-4.732, 4.800-4.803, 4.984-4.989, 4.1004-4.1012, 4.1032, 4.1037-4.1038, 4.1106, 4.1114, 4.1150-4.1154, 4.1161-4.1186, 4.1225, 4.1227.

<sup>23</sup>*Id.* paras. 7.50-7.51, 7.86-7.92, 7.113-7.120.

<sup>24</sup>*FSC Appeal*, *supra* note 14, paras. 26, 86, 101.

<sup>25</sup>*Id.* paras. 101-103.

<sup>26</sup>*Id.* paras. 174-177.

<sup>27</sup>*See supra* note 1.

<sup>28</sup>*See ETI Panel*, *supra* note 14, paras. 1.6- 1.8.

<sup>29</sup>*Id.* para. 9.1.

<sup>30</sup>*Id.* paras. 8.57-8.60, 8.66-8.67.

<sup>31</sup>*Id.* para. 8.71. *See also id.* paras. 8.72-8.74.

<sup>32</sup>*Id.* para. 8.94.

<sup>33</sup>*Id.* paras. 8.97-8.107.

<sup>34</sup>*ETI Appeal*, *supra* note 14, paras. 99-100.

<sup>35</sup>*Id.* paras. 142-145.

<sup>36</sup>*Arbitration Decision*, *supra* note 14, para. 8.1.

<sup>37</sup>*See* Tom Field and Chuck Gnaedinger, “FSC/ETI Compliance Effort May Spur Far-Reaching U.S. International Tax Changes,” 2002 *WTD* 238-3 (11 Dec. 2002) (noting Council of Economic Advisors Chair R. Glenn Hubbard’s recollection that, after the ETI Appellate Body decision, President Bush issued two instructions: “come into compliance with the WTO ruling with no more game playing” and “come up with tax revisions that would improve the competitiveness of U.S. firms”).

tion officials were predictably strong and consistent in advocating ETI repeal.<sup>38</sup> Others, however, were less accommodating. House Ways and Means Committee ranking member Rangel said the problem should be solved not by repealing ETI, but by negotiating a change in the WTO rules.<sup>39</sup> (He was contradicted fairly quickly by U.S. Trade Representative Robert B. Zoellick.)<sup>40</sup> Senator Max Baucus, D-Montana, Chairman of the Senate Finance Committee, echoed Rangel's approach<sup>41</sup> and later added that the WTO's proceedings were "looking more and more like a kangaroo court against U.S. trade laws."<sup>42</sup>

Chairman Thomas' response was more restrained. He said, "The WTO arbitration panel decision should not come as a surprise but rather as a reminder that the fundamental problems in our tax code need to be addressed now. . . . I have introduced legislation that addresses this problem by repealing FSC-ETI while modernizing sections of the U.S. Tax Code to enhance America's international competitiveness."<sup>43</sup>

Thomas had introduced bill H.R. 5095, the American Competitiveness and Corporate Accountability Act of 2002 (Thomas bill), on 11 July 2002.<sup>44</sup> The bill had three main sections, addressing competitiveness, corporate inversions, and tax shelters.<sup>45</sup> The

competitiveness section had 20 provisions: the ETI repeal, which would erase the ETI's 5.25 percent tax break for U.S. exporters,<sup>46</sup> and 19 other tax law changes intended to soften the repeal's impact. Those included:

- repeal of subpart F antideferral rules affecting foreign base company sales and service income;<sup>47</sup>
- repeal of the foreign personal holding company and foreign investment company rules;
- reform of interest allocation rules;
- reduction in the number of foreign tax credit (FTC) baskets from nine to three;
- extension of the FTC carryover period from 5 to 10 years; and
- repeal of the 90 percent limitation on FTC in Alternative Minimum Tax (AMT) calculations.<sup>48</sup>

Ultimately, the Thomas bill was not passed before the end of the 107th Congress, but it is expected that Chairman Thomas will reintroduce a similar bill later this year.<sup>49</sup>

## II. The E-VAT Directive

Shortly after the WTO Appellate Body issued its decision in the FSC case on 24 February 2000, the European Commission submitted a proposal to revise the application of VAT to online supply of digital products over the Internet.<sup>50</sup> Under Directive 77/388/EEC (Sixth Directive), those transactions were considered services for VAT purposes.<sup>51</sup> When

<sup>38</sup>See, e.g., Pamela F. Olson, "Pam Olson Letter to William M. Thomas on ETI Replacement," 2002 WTD 181-35, para. 15 (18 Sept. 2002); Kenneth W. Dam, "U.S. Treasury Deputy Secretary Dam Letter on International Competitiveness, WTO Decision," 2002 WTD 187-32 para. 3 (26 Sept. 2002).

<sup>39</sup>Charles Rangel, "Charles Rangel Release Responding to EU Sanctions List," 2002 WTD 180-19 (13 Sept. 2002).

<sup>40</sup>Robert B. Zoellick, "U.S. Trade Representative's Letter to W&M Member Charles Rangel on WTO Sanctions Threat on FSC/ETI Incentives," 2002 WTD 188-34 (27 Sept. 2002).

<sup>41</sup>Chuck Gnaedinger and Natalia Radziejewska, "White House Urges U.S. Senate Finance Committee To Repeal ETI Act," 2002 WTD 147-5 (31 July 2002).

<sup>42</sup>Chuck Gnaedinger and Natalia Radziejewska, "Baucus Deems WTO Dispute Settlement System 'Kangaroo Court' Against U.S.," 2002 WTD 188-1 (27 Sept. 2002). Senator Baucus also said, "The [WTO] appellate body's FSC decisions make an unworkable distinction between countries that rely primarily on direct taxes . . . and countries that rely primarily on indirect taxes. . . . Although the appellate body acknowledged countries' sovereign right to set their own tax systems, they interpret WTO rules in a way that heavily favors one particular system." *Id.*

<sup>43</sup>William M. Thomas, "U.S. Representative Thomas Statement on WTO's FSC-ETI Tax Arbitration Decision," 2002 WTD 171-29 (4 Sept. 2002).

<sup>44</sup>See Thomas bill, *supra* note 4.

<sup>45</sup>See *id.*; House Committee on Ways and Means, 107th Cong., Summary of Legislation, H.R. 5095, the "American Competitiveness and Corporate Accountability Act of 2002" (Competitiveness — Inversions — Tax Shelters) (visited 16 Apr. 2003) <http://waysandmeans.house.gov/legacy.asp?file=legacy/fullcomm/107cong/hr5095/hr5095summary.htm> (hereinafter Thomas bill summary); Rojas, *supra* note 5.

<sup>46</sup>See Thomas bill summary, *supra* note 45; Hufbauer, *supra* note 5, para. 24.

<sup>47</sup>Subpart F is codified at IRC sections 951-964. Sam Thompson has rightly observed that the proposed changes to subpart F could be a Trojan horse for the government, delaying taxation at the price of an increase in aggressive transfer pricing and the consequent time-consuming enforcement efforts that transfer pricing disputes entail. See Samuel C. Thompson, Jr., "The Thomas Bill: Right Direction on Inversions, Too Far on Repeal of Foreign Base Company Provisions, Not Far Enough on Tax Shelters," 2002 WTD 138-13, paras. 11-23 (18 July 2002).

<sup>48</sup>See Thomas bill, *supra* note 4; Gnaedinger, "EU, Business Groups," *supra* note 3.

<sup>49</sup>See Chuck Gnaedinger, "Hill Observers Expect International Tax Reform Legislation in 2003," 2003 WTD 12-10 (17 Jan. 2003).

<sup>50</sup>See Proposal for a Council Directive Amending Directive No 77/388/EEC, 2000 O.J. (C 337 E) 65 (hereinafter Proposal) (submitted by the European Commission on 7 June 2000).

<sup>51</sup>Council Directive 77/388/EEC of 17 May 1977 on the Common System of Value Added Tax, arts. 6(1), 9 1977 O.J. (L 145) 1 (hereinafter Sixth Directive).

rendered by an EU trader, VAT applied to the sale, but when rendered by a non-EU supplier to an EU consumer, no VAT was assessed.<sup>52</sup> That obvious disadvantage led to amendment of the Sixth Directive on 7 May 2002 by Directive 2002/38/EC (E-VAT Directive).<sup>53</sup>

The E-VAT Directive requires non-EU merchants worldwide to begin paying VAT on 1 July 2003 for certain online sales of e-products including software, databases, images, text, music, films, games, and “distance teaching.”<sup>54</sup> Sales to nontaxable persons in the European Community, that is, individuals and entities that do not themselves pay VAT directly to their governments, will be taxed at the applicable rate for VAT in the recipient’s member state.<sup>55</sup> EU “taxable persons” buying e-commerce services from non-EU suppliers will continue to self-assess VAT on their purchases and pay it with their regular VAT returns.<sup>56</sup>

Under a new “special scheme for non-established taxable persons supplying electronic services to non-taxable persons,” non-EU suppliers who are not already registered for VAT in an EU country will be allowed to register for VAT online in the EU country of their choice.<sup>57</sup> Thereafter, they will file quarterly online returns, whether they have made any sales during the quarter or not.<sup>58</sup> Those returns will list sales by country, noting the applicable tax rates and the total tax due, and will include payment in local currency to a designated bank account.<sup>59</sup>

Although the professed rationale for the E-VAT Directive was the creation of a “level playing field” for EU-based and non-EU “e-tailers,”<sup>60</sup> there are several respects in which the directive places non-EU suppliers at a distinct disadvantage. First, non-EU e-tailers have to register, file returns, and pay VAT from the first sale they make, regardless of its size or the likelihood of additional sales.<sup>61</sup> Many small EU e-tailers, however, do not even have to register, much less pay VAT, until their turnover exceeds a certain threshold amount.<sup>62</sup> That threshold varies from €5,580 in Belgium to around €80,000 (£56,000) in the United Kingdom.<sup>63</sup> Thresholds reflect, in part, a recognition that the burden of administrative compliance with VAT is substantial, especially for small businesses.<sup>64</sup>

<sup>60</sup>See E-VAT Opinion, *supra* note 52, at 62; Chuck Gnaedinger, “EU Commissioner Defends Call to Limit Reach of U.S. Corporate Governance Rules,” 2003 WTD 38-1 (26 Feb. 2003) (quoting EU Tax Commissioner Frits Bolkestein); EU Commission, “EU Commission Release on Council’s Adoption of E-Commerce VAT Rules,” 2002 WTD 89-19 (8 May 2002).

<sup>61</sup>E-VAT Directive, *supra* note 11, at art. 1(3)(B).

<sup>62</sup>Exemptions from VAT on sales by domestic small enterprises exist in many of the EU member states. See Fabiola Annacondia and Walter van der Corput, “VAT Registration Thresholds in Europe,” 13 *Int’l VAT Monitor* 487, 487-488 (2002); European Commission, *VAT in the European Community* (2002), Annex I (visited 5 Mar. 2003) [http://europa.eu.int/comm/taxation\\_customs/publications/info\\_doc/taxation/tva/vat\\_ec2000\\_en.pdf](http://europa.eu.int/comm/taxation_customs/publications/info_doc/taxation/tva/vat_ec2000_en.pdf) (hereinafter *VEC*); *Value Added Taxation in Europe* (2002), IV Guides to European Taxation, Belgium section 13.3., Denmark sections 2.1.2., 2.1.6., Germany section 13.3., Greece section 13.3., France section 13.1.1.3., Ireland section 13.4., Luxembourg section 13.3.1., Austria section 13.3., Portugal section 7.5.1.1., Finland section 13.4., United Kingdom section 15.3.1. (hereinafter *VATE*). Those exemptions do not apply to traders established outside the respective countries, a category that would include non-EU e-tailers. Sixth Directive, *supra* note 51, at art. 28i (amending art. 24). In some member states, those affected by small enterprise provisions do not even have to register for VAT. See, e.g., *Guide to Value-Added Tax [in Ireland] 10<sup>th</sup> Edition*, chap. 2.2 (2003) (visited 6 Apr. 2003) [http://www.revenue.ie/pdf/vatguide\\_03.pdf](http://www.revenue.ie/pdf/vatguide_03.pdf); *VATE*, *supra*, at Denmark section 2.3.1., United Kingdom section 15.2.(A).

<sup>63</sup>Annacondia and van der Corput, *supra* note 62, at 487-488; U.K. Customs and Excise, “U.K. Customs and Excise Further Updates Budget 2003 VAT Changes,” 2003 WTD 84-10 (1 May 2003).

<sup>64</sup>See E-VAT Opinion, *supra* note 52, at 63; European Commission, Explanatory Memorandum accompanying Proposal, *supra* note 50, section 5.2 (visited 31 Mar. 2003) [http://europa.eu.int/servlet/portail/RenderServlet?search=ReffPub&lg=en&nb\\_docs=25&domain=&in\\_force=NO&year=2000&month=&day=&coll=JOC&nu\\_jo=337&page=65](http://europa.eu.int/servlet/portail/RenderServlet?search=ReffPub&lg=en&nb_docs=25&domain=&in_force=NO&year=2000&month=&day=&coll=JOC&nu_jo=337&page=65) (choose the HTML version of the Proposal to view the Explanatory Memorandum); William J. Turnier, “Accommodating to the Small Business Problem under a VAT,” 47 *Tax Law* 963, 963-966 (1994).

<sup>52</sup>*Id.* at arts. 2(1), 9(1); **Opinion of the Economic and Social Committee on ‘Proposal for a Council Directive Amending Directive No 77/388/EEC,’ 2001 O.J. (C 116) 59, 61** (hereinafter E-VAT Opinion).

<sup>53</sup>See E-VAT Directive, *supra* note 11. The E-VAT Directive did not change the Sixth Directive’s characterization of e-products as services.

<sup>54</sup>*Id.* at art. 4, Annex L. Free online services will not be taxed because they fall outside the scope of VAT. See Sixth Directive, *supra* note 51, at art. 2(1) (restricting application of VAT to “goods and services effected for consideration”). Strictly speaking, it will not be the E-VAT Directive itself that imposes the duty to pay VAT. See *supra* note 10.

<sup>55</sup>E-VAT Directive, *supra* note 11, at art. 1(1)(b) (adding subsection (f) to Sixth Directive art. 9(2)).

<sup>56</sup>Sixth Directive, *supra* note 51, at art. 21(1)(b).

<sup>57</sup>E-VAT Directive, *supra* note 11, at art. 1(3) front language, (B)(2). E-VAT Directive Article 1(3) creates a new Article 26c in the Sixth Directive, *supra* note 51, with the same subsections as Article 1(3).

<sup>58</sup>*Id.* at art. 1(3)(B)(5).

<sup>59</sup>*Id.* at art. 1(3)(B)(5)-(8).

The original E-VAT proposal by the European Commission included a provision for a €100,000 threshold for non-EU suppliers of electronic services.<sup>65</sup> That provision was eliminated in the final version of the E-VAT directive, leaving non-EU e-tailers to charge VAT and shoulder administrative burdens, while many of their small EU competitors are required to do neither.<sup>66</sup>

**Rangel said the problem should be solved, not by repealing ETI, but by negotiating a change in the WTO rules.**

Second, non-EU e-tailers participating in the special scheme have to stand ready to comply with an audit of their returns by any EU country in which they have made sales.<sup>67</sup> EU e-tailers, on the other hand, are by and large subject to VAT audits only in the member state, or states, where they are registered.<sup>68</sup> Inquiries from other countries are possible, but they require involvement of the registering state's competent authority,<sup>69</sup> and the presence of officials from another country at the examination of an EU trader usually is subject to the trader's permission.<sup>70</sup> Those safeguards and limitations will not apply for non-EU e-tailers using the special scheme created by the E-VAT

Directive. The effect for audit purposes will be the same as if the non-EU trader were registered in every country where one sale is made. In addition, with respect to audits after 1 January 2004, non-EU e-tailers may be required to produce translations of their invoices into one or more of the 11 official languages of the Community.<sup>71</sup> The likelihood of multiple examinations has to consider the relative ease with which they could be initiated. Where examination of an EU trader from another state would require contact with an official from that state,<sup>72</sup> examination of a non-EU e-tailer could theoretically be initiated directly by an e-mail. The prospect of multiple audits in multiple languages, easily initiated, is a burden that EU e-tailers will not face.<sup>73</sup>

Third, and perhaps most important, although non-EU e-tailers will have to charge nontaxable persons the VAT rate of the recipient's country, EU e-tailers still will charge the VAT rate of the country in which they are located and registered.<sup>74</sup> Therefore, when nontaxable e-commerce customers living in high-VAT countries like Denmark or Sweden (both 25 percent) have a choice between an EU e-tailer located in a lower-VAT EU country like Luxembourg (15 percent), Spain (16 percent), or Germany (16 percent),<sup>75</sup> and a non-EU e-tailer who will have to assess VAT at the rate of their home countries, pushing

<sup>65</sup>See Proposal, *supra* note 50, at 66 (art. 1(3), proposing amendment of the Sixth Directive, *supra* note 51, at art. 24(2)(a)).

<sup>66</sup>See E-VAT Directive, *supra* note 11. Nancy Perks, Microsoft's director for international tax, has noted that the absence of a threshold "undermines the legitimacy of the directive" because it allows VAT to be imposed before there is a "nexus for tax liability." Chuck Gnaedinger, "U.S. Has Grounds to Challenge EU's E-VAT Directive, PwC's Merrill Says," *2003 WTD 41-4* (3 Mar. 2003).

<sup>67</sup>E-VAT Directive, *supra* note 11, at art. 1(3)(B)(9) ("The non-established taxable person shall keep records of the transactions covered by this special scheme in sufficient detail to enable the tax administration of the Member State of consumption to determine that the value added tax return . . . is correct. These records should be made available electronically. . . .").

<sup>68</sup>Liability under a member state's VAT usually requires, in the case of services, a fixed establishment within the member state. See Case C-190/95, *ARO Lease BV v. Inspecteur van de Belastingdienst Grote Ondernemingen te Amsterdam*, 1997 E.C.R. I-4383, Grounds paras. 24-27; Case 168/84, *Berkholz v. Finanzamt Hamburg-Mitte-Altstadt*, 1985 E.C.R. 2251, Grounds paras. 15-19.

<sup>69</sup>Report from the Commission to the Council and the European Parliament — Third Article 14 Report on the Application of Council Regulation (EEC) No 218/92 of 27 January 1992 on Administrative Cooperation in the Field of Indirect Taxation (VAT) and Fourth Report under Article 12 of Regulation (EEC, Euratom) No 1553/89 on VAT Collection and Control Procedures, COM/2000/0028 final at section 6.7.5.

<sup>70</sup>*Id.* section 6.7.6.

<sup>71</sup>Sixth Directive, *supra* note 51, at art. 22(3)(b), as amended by art. 28h.

<sup>72</sup>See *supra* text accompanying note 69.

<sup>73</sup>Nine members of the U.S. House of Representatives Energy and Commerce Subcommittee on Commerce, Trade, and Consumer Protection have expressed concern regarding this risk, as has the Electronic Commerce Tax Study Group (ECTSG). See Cliff Stearns et al., "U.S. Lawmakers Demand White House Support on EU E-Commerce VAT Directive," *2002 WTD 150-28* (5 August 2002); ECTSG, "U.S. Tax Group Writes EU Commissioner on Proposed E-Commerce VAT Directive," *2002 WTD 29-20* (12 Feb. 2002).

<sup>74</sup>See E-VAT Directive, *supra* note 11, at art. 1(1)(b) (adding subsection (f) to Sixth Directive, art. 9(2)); Sixth Directive, *supra* note 51, at art. 9(1). Peter Merrill, director of the National Economic Consulting Group at PricewaterhouseCoopers, has stated that this aspect of the E-VAT Directive makes it vulnerable to a WTO challenge. See Gnaedinger, *supra* note 66. The U.S. Council for International Business and Deputy Treasury Secretary Kenneth W. Dam have raised the same concern. See Thomas M. T. Niles, "Organization Concerned About Directive That Applies VAT on E-Commerce," *2003 WTD 51-48* (15 Mar. 2003); Kenneth W. Dam, "U.S. Treasury Official Notes U.S. 'Concerns' With EU E-Commerce Tax Proposal," *2002 WTD 28-41* (11 Feb. 2002).

<sup>75</sup>See "Practical Information on VAT[.] January 2003," 14:1 *Int'l VAT Monitor* 1, 3, 5, 7 (2003) (green pages). Standard VAT rates apply under the E-VAT Directive. Sixth Directive, *supra* note 51, at art. 12(3)(a), as amended by E-VAT Directive, *supra* note 11, at art. 1(2).

the “buy” button on the EU vendor’s Web site will be the obvious choice.<sup>76</sup> The best way for all e-tailers to avoid that situation will be to create fixed establishments in the low-VAT EU countries and register under the general VAT rules, and there were reports as early as summer 2002 that was occurring.<sup>77</sup>

Finally, under the E-VAT Directive’s special scheme,<sup>78</sup> non-EU e-tailers will not be allowed to deduct their input VAT on their VAT returns, as EU taxable persons may,<sup>79</sup> but rather will be required to file their returns, remit all their output VAT (the VAT due on sales), and *then* apply separately for refunds of their input VAT.<sup>80</sup> Not only does that deprive them of the time value of their input VAT between the date the return and refund request are filed and the date the refund is received, it more importantly imposes double the administrative burden that their EU competitors face. Those competitors only file the VAT return if above-threshold, or (usually) no return if below-threshold.<sup>81</sup> Further, not only are below-threshold EU competitors almost totally relieved of administrative burdens,<sup>82</sup> they are, as noted, exempt from collecting any VAT at all and, therefore, enjoy an automatic price advantage over and above their lower administrative costs.<sup>83</sup>

To sum up, non-EU e-tailers will be forced to charge VAT from the first euro of sales, while small EU competitors charge none, they sometimes will be forced to charge a higher VAT rate than their EU competitors,

and they will have to bear additional administrative burdens, in the form of additional forms to file for rebates of their input VAT and exposure to audits by every country in which they make sales. The only solution, as noted, is to relocate to or expand to a low-VAT EU country so that the special scheme of the E-VAT Directive need not apply. The E-VAT Directive is therefore a two-sided message to non-EU e-tailers. On its face is an invitation: “Come join us.” On its reverse is a threat: “Or else.”<sup>84</sup>

### III. Foreign Tax Creditability For VATs

Contrary to the EU’s invitation, both the U.S. President and many in Congress are interested in keeping jobs and investment in the United States.<sup>85</sup> As noted, the most common complaint about the Thomas bill last year was that it would benefit only businesses with an overseas presence — only multinationals.<sup>86</sup> The recent Crane-Rangel bill addresses that concern.<sup>87</sup> Granting foreign tax credit for VATs is another approach that will provide targeted relief for American businesses that sell overseas, including those with limited or no foreign operations<sup>88</sup> and those that will be disadvantaged by the inequities of the E-VAT Directive.

The foreign tax credit was introduced in 1918 for “income, war-profits and excess-profits taxes,”<sup>89</sup> and although it included both per-country and type-of-tax limitations, Congress added a proportional limitation

<sup>76</sup>That assumes that the non-EU and EU e-businesses have roughly equal prices and that the non-EU e-tailer does not lower its price 8 percent to make its high-VAT-inclusive price match or beat the low-VAT-inclusive price of the EU merchants. If the non-EU e-tailer *did* reduce its price, the lower profit it would receive would be a particularly transparent example of partial nonshiftability of the high VAT.

<sup>77</sup>Christine Sanderson et al., “Remote Control: A Guide for U.S. E-Commerce Vendors to the New EU VAT Directive,” 2002 WTD 107-18 (3 June 2002).

<sup>78</sup>See *supra* note 57.

<sup>79</sup>Sixth Directive, *supra* note 51, at arts. 17-18.

<sup>80</sup>E-VAT Directive, *supra* note 11, at art. 1(3)(B)(9). The Electronic Commerce Tax Study Group has expressed concern regarding that aspect of the E-VAT Directive. See ECTSG, *supra* note 73.

<sup>81</sup>One member state, Austria, requires some small entrepreneurs to register and file returns even though they owe no VAT. E-mail from Timothy Hayes, Principal Administrator, VAT and Other Turnover Taxes Unit, European Commission to Martin B. Tittle (24 Mar. 2003) (on file with the author) (noting that small entrepreneurs in Austria owe no VAT if their annual turnover is less than €22,000, but that they nevertheless have to file annual VAT returns if their turnover exceeds €7,500).

<sup>82</sup>See *supra* note 62 (noting member states where registration of qualifying small enterprises is not required).

<sup>83</sup>See *supra* notes 62-64 and accompanying text.

<sup>84</sup>Additional objections to the E-VAT Directive not discussed here include the present inability of the EU to offer real-time, on-line confirmation of VAT numbers and the lack of a safe harbor when e-customers lie about their taxable status or location. For discussions of these issues, see Sanderson, *supra* note 77 (noting that it now takes at least a week for local EU authorities to verify a customer’s VAT number); Gnaedinger, *supra* note 66; Stearns et al., *supra* note 73; Niles, *supra* note 74. A safe harbor for good-faith efforts to determine a customer’s taxable status was included in the proposed directive. See Proposal, *supra* note 50, at art. 1(4).

<sup>85</sup>See *supra* note 37; Sander M. Levin, “Levin Release on EU ETI Sanctions List,” 2003 WTD 40-20 (28 Feb. 2003) (“If the U.S. Government is going to seriously consider a legislative remedy, it cannot be at the expense of American firms, workers, and exporters, as would occur under the approach advanced by Mr. Thomas and the Administration.”); Rangel, *supra* note 5; Crane and Rangel, *supra* note 5.

<sup>86</sup>See *supra* note 5.

<sup>87</sup>See *supra* note 6.

<sup>88</sup>See *infra* notes 121-125 and accompanying text.

<sup>89</sup>Joseph Isenbergh, “The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes,” 39 *Tax L. Rev.* 227, 230 (1984) (quoting Revenue Act of 1918, ch. 18, section 222(a), 40 Stat. 1057).

in 1921 to prevent high foreign tax rates from effectively sheltering U.S.-source income.<sup>90</sup> The original reason for limiting creditability to income-type taxes remains a mystery. No explanation was included in the 1918 Act, and, surprisingly, none has been enunciated in subsequent legislation.<sup>91</sup> In 1956, Stanley Surrey speculated that the basis for the limitation might lie in the purported “nonshiftability” of income taxes.<sup>92</sup> “Shifting” taxes, he explained, were those whose economic incidence was generally assumed to be passed on from the statutory or nominal payor to someone else.<sup>93</sup> Examples included sales, turnover, and excise taxes.<sup>94</sup> Income taxes, on the other hand, were generally assumed to be “nonshiftable,” and therefore actually borne, or suffered, by the taxpayer.<sup>95</sup> Five years later, Elisabeth Owens came to the same conclusion, saying “the chief determinative factor in deciding whether a tax qualifies for the credit should be whether or not the tax is shifted or passed on by the person paying the tax.”<sup>96</sup> Joseph Isenbergh repeated that theory of creditability in 1984, calling it the “only plausible explanation that has ever appeared for limiting the foreign tax credit to income taxes.”<sup>97</sup> The issue of shiftability is not merely a technical one. As Judge Karen Nelson Moore has correctly noted, “the goal of achieving tax neutrality between foreign and domestic investment [sometimes called capital export neutrality, or CEN] is satisfied [only] if taxes do not alter the relative rates of return on investments; allowance of a tax credit limited to taxes that are not shifted to others is consistent with that goal, since taxes that can be shifted do not affect the taxpayer’s rate of return.”<sup>98</sup>

<sup>90</sup>*Id.* That proportional limitation, slightly amended, still applies today. See IRC section 904(a).

<sup>91</sup>Karen Nelson Moore, “The Foreign Tax Credit for Foreign Taxes Paid in Lieu of Income Taxes: An Evaluation of the Rationale and a Reform Proposal,” 7 *Am. J. Tax Pol’y* 207, 213-215 (1988).

<sup>92</sup>Stanley S. Surrey, “Current Issues in the Taxation of Corporate Foreign Investment,” 56 *Colum. L. Rev.* 815, 820-821 (1956).

<sup>93</sup>*Id.*

<sup>94</sup>*Id.*

<sup>95</sup>*Id.* at 821.

<sup>96</sup>Elisabeth Owens, *The Foreign Tax Credit* 83 (1961), quoted in Moore, *supra* note 91, at 217-218.

<sup>97</sup>Isenbergh, *supra* note 89, at 288.

<sup>98</sup>Moore, *supra* note 91, at 217. Judge Moore was paraphrasing Owens, *supra* note 96, at 84: “The economic function of the foreign tax credit is to remove a disincentive to the free flow of international trade and investment from the United States. The objective is to allow the investor to choose between foreign and domestic business operations free from tax considerations. Since this choice depends upon the rates of return after taxes, a credit should be given only for taxes which are not passed on because it only those taxes which affect profits after taxes.”

Shiftability and nonshiftability are understood today not as separate states that are fixed characteristics of different taxes, but as the opposite ends of a continuum across which all taxes move in response to market circumstances. In 1989, Judge Moore reviewed over 40 sources before saying, “The tax policy maker must conclude that a conclusive answer is not available today to the question whether the corporate income tax is shifted or whether it is in fact borne by the corporation and its owners.”<sup>99</sup> That question has not been resolved in the years between 1989 and the present.<sup>100</sup> Similarly, Liam Ebrill and his co-authors freely admit in the International Monetary Fund’s book *The Modern VAT* that “[t]he effective incidence of a VAT, like that of any other tax, is determined not by the formal nature of the tax but by market circumstances, including the elasticity of demand for consumption and the nature of competition between suppliers. . . . The real burden of the VAT tax may not fall entirely on consumers but may in part be passed back to suppliers of factors through lower prices received by producers.”<sup>101</sup> The VAT that U.S. e-tailers will be required to pay under the E-VAT Directive is likely to be nonshiftable either largely or completely because they will face EU competition that can charge lower VAT and no VAT.<sup>102</sup> Judge Moore’s solution to the income tax’s quasi-shiftable character was to suggest that the foreign tax credit be eliminated as a windfall, and that foreign income taxes be returned to their pre-1918, deductible-only status.<sup>103</sup> However, an equally rational solution would be to continue the credit for income taxes, so as not to disadvantage businesses when income taxes cannot be shifted, and, with appropriate limitations, to expand the credit to VATs and other taxes that, like income taxes, are sometimes nonshiftable.<sup>104</sup>

<sup>99</sup>*Id.* at 222. Despite that statement, Judge Moore continued, in the same sentence as that quoted, “however, it seems likely that a substantial part of the corporate income tax is indeed shifted.” An alphabetized list of the 42 sources consulted by Judge Moore is available on request.

<sup>100</sup>See, e.g., Douglas A. Kahn and Jeffrey S. Lehman, *Corporate Income Taxation* 22-25 (5th ed. 2001) (noting “substantial uncertainty about the incidence of the corporate income tax”); Cheryl D. Block, *Corporate Taxation* 14 (1998) (noting that the extent and direction of corporate tax shifting “is the subject of much debate and the incidence question remains unresolved”).

<sup>101</sup>Ebrill et al., *supra* note 12, at 15, 76.

<sup>102</sup>See *supra* text accompanying notes 62-63, 74-76.

<sup>103</sup>Moore, *supra* note 91, at 226.

<sup>104</sup>See Isenbergh, *supra* note 89, at 294-295 (suggesting expansion of the foreign tax credit to include all foreign taxes and noting that, if the amount of the credit is capped, “the Treasury has little reason to care about [the foreign government’s] precise methods [of taxing]”).

The fact that the shiftability of both income taxes and VATs varies dynamically in step with market forces is indicative of a broader similarity. Direct taxes (income taxes) and indirect taxes (VATs) are not opposites, but rather are alternate methods for allocating the same tax burdens. For example, it is widely acknowledged that VATs amount to a “combination of several direct taxes: a direct tax on profits earned by the corporation, a direct tax on interest and rent paid by the corporation, and a direct tax on wages.”<sup>105</sup> On the other hand, taxes that, under WTO rules, must be classified as direct are sometimes so similar to VATs that the difference is not substantive. For instance, the flat tax proposed by Congressman Richard Armey and Senator Richard Shelby in 1995<sup>106</sup> was essentially a flat-rate subtraction VAT in which collection of the tax had been divided between business and individuals.<sup>107</sup> That division of collection was not considered significant by knowledgeable observers, including University of California, Berkeley economics and law professor Alan J. Auerbach.<sup>108</sup> It was, however, enough to make the flat tax a direct, and not an indirect, tax under existing WTO rules.<sup>109</sup> As such, it could not have been remitted on exports and applied to imports, as VATs are, despite the fact that it was in essence a “broad-based flat rate consumption tax.”<sup>110</sup> In the face of that virtual equivalence, it is no wonder that Chairman Thomas, supported by Senators Baucus and Grassley and Gary Hufbauer of the Institute for International Economics, has said that the distinction between direct and indirect taxes is, “in today’s world,

... a distinction without a difference.”<sup>111</sup> Recognition of both the economic parity between income taxes and VATs and their equivalence in meeting the foreign tax credit criterion of nonshiftability strongly suggests that both income taxes and VATs should be creditable.<sup>112</sup>

The standards for creditability of VATs may need to be slightly more stringent than the standards for income taxes. The three criteria for income tax creditability are: (1) the tax must be due from the taxpayer (the “technical taxpayer” rule), (2) there must be proof of payment, and (3) the tax must not have been refunded.<sup>113</sup> The first and third of those should be applied to VATs without change. With respect to the second, however, the “gross-up” rule allows foreign tax credit for taxes paid by others, as long as the taxpayer claiming credit was liable for the tax.<sup>114</sup> If that rule were applied to VAT creditability, then in theory everyone with an invoice showing a charge for VAT might claim a tax credit. Allowing credits on that basis would undermine the rationale for extending credit in the first place — to prevent double taxation from discouraging business activity abroad<sup>115</sup> — because people who make a single purchase abroad are not necessarily attempting to engage in business activity there, even if the purchase is for business purposes. It

<sup>105</sup>Hufbauer, *supra* note 5, para. 13. See also Ebrill et al., *supra* note 12, at 18-19, 198 (a VAT “levied at a uniform rate on all commodities” is equivalent to “a cash flow business tax and a tax on wage earnings”; if, in addition, “the VAT rate is constant over time,” it is equivalent to “a tax on pure profits, a capital levy, and a tax on wage earnings”; if the VAT is applied to imports and remitted on exports, it is also a “uniform export subsidy/import tax”).

<sup>106</sup>Freedom and Fairness Restoration Act of 1995, H.R. 2060, 104th Cong. (1995); S. 1050, 104th Cong. (1995), cited in Stephen E. Shay and Victoria P. Summers, “Selected International Aspects of Fundamental Tax Reform Proposals,” 51 *U. Miami L. Rev.* 1029, 1030 n.4 (1997).

<sup>107</sup>See Michael J. Graetz, “International Aspects of Fundamental Tax Restructuring: Practice Or Principle?,” 51 *U. Miami L. Rev.* 1093, 1094-1095 (1997).

<sup>108</sup>*Id.* at 1095 (citing Professor Auerbach’s Congressional testimony).

<sup>109</sup>See SCM, *supra* note 20, at Annex I n.58. See also Shay and Summers, *supra* note 106, at 1054.

<sup>110</sup>Graetz, *supra* note 107, at 1097; see Reuven S. Avi-Yonah, “From Income to Consumption Tax: Some International Implications,” 3 *San Diego L. Rev.* 1329, 1335 (1996).

<sup>111</sup>See Gnaedinger and Radziejewska, *supra* note 7 (quoting Thomas and noting Baucus’ statement that the FSC tax breaks were “no more trade-distorting” than the EU states’ VAT rebates); Hufbauer, *supra* note 5, para. 12 (“[W]hatever basis the simple direct/indirect dichotomy may have had in the bygone world of property and excise taxes, it lost its rationale when a line was drawn between permitted border adjustments for the VAT and the corporate income tax.”); Field and Gnaedinger, *supra* note 37 (quoting Hufbauer as saying, “The direct/indirect tax dichotomy is false in today’s context.”); cf. Gnaedinger and Radziejewska, *supra* note 42 (quoting Baucus as saying, “The [WTO] appellate body’s FSC decisions make an unworkable distinction between countries that rely primarily on direct taxes . . . and countries that rely primarily on indirect taxes.”); Gnaedinger and Radziejewska, *supra* note 41 (quoting Senator Grassley as saying, “How can we justify allowing this distinction to continue?”).

<sup>112</sup>See *supra* notes 98-104 and accompanying text. Alternate bases for extending foreign tax credit to VATs could include the competitive needs of U.S. businesses, see Glenn E. Coven, “International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes,” 4 *Fla. Tax Rev.* 83, 86 (1999), or the fact that VAT is the “principal tax” of various foreign countries. See Surrey, *supra* note 91, at 820 (noting the need, in 1954, to exclude sales and turnover taxes from the “principal tax” proposal). The nonshiftability criterion, on the other hand, has the advantage of being a classic theory, and thus does not require “breaking new ground” to validate VAT creditability.

<sup>113</sup>See IRC 1.901-2(f) (the “technical taxpayer” rule); 1.905-2 (taxpayer must present proof of payment); 1.905-3T (refund of a foreign tax constitutes a change in foreign tax liability).

<sup>114</sup>IRC section 1.901-2(f)(1)-(2).

<sup>115</sup>See *supra* note 98 and accompanying text.

would be possible to bar those claims on the ground that the taxpayer could not demonstrate that the tax shown on the invoice had actually been paid by the party issuing the invoice (that is, that it had not been partially or totally offset by deductions). Alternatively, it could be argued that the claimant was not the “technical taxpayer.” That argument would be more tenuous because all taxable persons must pay VAT,<sup>116</sup> and the term “taxable persons” includes everyone “who independently carries out in any place” any of the economic activities of “producers, traders, and persons supplying services.”<sup>117</sup> That category includes even those who, as members of special classes, are exempted from payment,<sup>118</sup> and, therefore, it might also include casual purchasers. Therefore, unless there is a clear advantage in keeping the criteria for income tax and VAT creditability identical and addressing this issue in an exception, VAT creditability should require that the taxpayer demonstrate direct payment of VAT to the foreign government. That proof could be a VAT return and payment authorization, or, if no VAT return has been or will be filed, it could be the receipt issued to the taxpayer or its representative by customs when VAT was paid at the time of importation into the VAT jurisdiction. Either way, those with no more than an invoice showing a charge for VAT should not be able to claim the credit.

### **A U.S. e-tailer will be liable for VAT under the 15 national statutes implementing the E-VAT Directive.**

U.S. e-tailers will meet those three requirements automatically when they comply with the E-VAT Directive. They will be liable for VAT under the 15 national statutes implementing the E-VAT Directive; they will be paying, on a quarterly basis, the VAT due on their retail EU sales;<sup>119</sup> and unless they have input VAT and apply for a refund,<sup>120</sup> no VAT will be refunded to them. U.S. multinationals also will meet those requirements with respect to the VAT legislation of the countries where their branches and subsidiaries are located. In addition, U.S.-based businesses with no foreign presence will meet those requirements when they sell goods to EU businesses and the transactions

<sup>116</sup>Sixth Directive, *supra* note 51, at art. 22(5), as amended by art. 28h.

<sup>117</sup>*Id.* at art. 4(2)-(3).

<sup>118</sup>*See, e.g., id.* at art. 24 (allowing exemption of small enterprises from VAT).

<sup>119</sup>E-VAT Directive, *supra* note 11, at art. 1(3)(B)(5)-(7).

<sup>120</sup>*Id.* at art. 1(3)(B)(8).

require that they be the importing parties.<sup>121</sup> As a general rule, import VAT is due on goods imported into the European Union at the same rate as if the goods had been supplied from within the country.<sup>122</sup> The importer usually is designated as the party to pay that VAT,<sup>123</sup> and if the U.S. business imports the goods itself, then it will owe, and have to pay, the import VAT. Setting up this kind of transaction can require appointment of a VAT representative in the country to which the goods will be shipped,<sup>124</sup> but in many cases, the EU business-buyer will be qualified to fill that post.<sup>125</sup>

Will VAT creditability pass WTO muster? Almost certainly. The right of a nation to offer its own citizens credit for foreign taxes actually paid has never been disputed, either in the WTO or in GATT, probably because the credit is not “specifically related to exports”;<sup>126</sup> it is available to everyone. It is true that, in the past, the foreign taxes available for credit were imposed on the basis of what the ETI appellate body opinion called “some link” to the taxing state.<sup>127</sup> The appellate body gave permanent establishments and “conduct of a trade or business” as examples of those

\* Update: See Notice 2004-19, 2004-11 IRB 606 (withdrawing Notice 98-5); cf. Notice 2003-76 (making the transactions in Part II of Notice 98-5 listed transactions).

<sup>121</sup>Legislation enabling VAT creditability should address the possibility that transactions like these may be inaccurately labeled abusive if their profit margins are lower than the applicable VAT rates. *See* Notice 98-5, 1998-1 C.B. 334.\*

<sup>122</sup>Sixth Directive, *supra* note 51, at arts. 2(2), 12(5).

<sup>123</sup>*Id.* at art. 21(4) (allowing member states to designate the party responsible for paying import VAT); *see, e.g., VATE, supra* note 62, at Belgium section 15.2.1. (designating the importing party as responsible for paying import VAT), Denmark section 15.2.1.2. (same), Germany section 15.5.1.1. (same).

<sup>124</sup>Ireland and the United Kingdom do not require designation of a tax representative. *See VATE, supra* note 62, at Ireland section 15.2.4.2.; *VEC, supra* note 62, at 159.

<sup>125</sup>*See, e.g., Moquet Borde and Lovells, Doing Business in France*, section 13.06[6][iv] (2002) (“A Non-Domiciliary normally appoints the person to whom he sells taxable goods or renders taxable services as his VAT representative.”); *VATE, supra* note 62, at Greece section 15.2.4.1. (“A representative can be any natural or legal person residing or having its legal seat or its permanent establishment in Greece.”); Italy section 15.2.1.2. (“The representative may either be an individual or a legal person (such as a company), and must be resident in Italy.”); cf. Denmark section 15.3.4.2. (a fiscal, or VAT representative “can be a person who is resident in Denmark or . . . can be an enterprise with a business establishment in Denmark,” but “authorized public accountants cannot act as fiscal representatives”). A customs agent may also be needed, but if the EU customer is serving as the supplier’s VAT representative and has previous importing experience, he may be qualified to address that need.

<sup>126</sup>SCM, *supra* note 20, at Annex I(e) (listing the “full or partial exemption, remission, or deferral, specifically related to exports, of direct taxes” as an example of an export subsidy).

<sup>127</sup>*ETI Appeal, supra* note 2, para. 143.

links.<sup>128</sup> In the past, links of that kind applied, not only with respect to liability for income taxes, but also with respect to liability for VAT on services.<sup>129</sup>

Now, however, with the E-VAT Directive, the EU has changed all that. It has made persons with no links, other than a single sale, liable for VAT on that sale.<sup>130</sup> That liability is direct. Non-EU e-tailers are not mere collectors and remitters of VAT due from their customers. The language of the directive makes clear that “non-established taxable person[s],” as it categorizes non-EU e-tailers, are directly liable for payment of the VAT due on applicable sales.<sup>131</sup> Whatever the taxpayer “link” that justifies imposing the liability, all the United States would seek by granting foreign tax credit for VATs would be to ameliorate, at least in part, the impact of the tax actually imposed on U.S. businesses.

That VAT creditability is not an export subsidy is shown by the fact that it passes the three SCM tests that the ETI failed. First, it does not constitute a forgoing of tax otherwise due under SCM article 1<sup>132</sup> because, according to the ETI Appellate Body, foreign tax credits are included in the benchmark for U.S. taxation of foreign-source income.<sup>133</sup> Only measures like FSC and ETI that reduce taxes below the benchmark fail the “but for” test and amount to a foregoing of tax otherwise due.<sup>134</sup> Second, even if VAT creditability failed the “but for” test, it still would not

be a subsidy because there would be no SCM article 1.1(b) “benefit” conferred on the taxpayer.<sup>135</sup> The taxpayer would still have paid the tax for which credit was given. To find otherwise would be, in essence, to hold that the credit method of avoiding double taxation is a subsidy, and if that were to occur, then it seems likely that the territorial exemption method also would be a subsidy because the two have long been considered equivalent.<sup>136</sup> However, if VAT creditability were nevertheless found to be a subsidy, it would not be a prohibited, SCM article 3.1(a), export-contingent subsidy because it complies with the ETI panel’s neutralization prescription. As noted, the ETI panel said that the way to neutralize export-contingency was to allow the same subsidy on goods sold for use in the domestic market.<sup>137</sup> Under that rule, VAT creditability could not be export-contingent because there would be nothing to prevent its beneficiaries from manufacturing goods partially or wholly outside the United States and then selling them into the domestic market.<sup>138</sup> Therefore, extension of foreign tax credit to VATs will be fully compliant with the United States’ WTO obligations.<sup>139</sup>

<sup>128</sup>*Id.*

<sup>129</sup>As recently as 1997, the “mere presence in Belgium of a fleet of cars owned by [Dutch automobile leasing firm] ARO” was insufficient to make the resulting revenues subject to Belgian VAT. *See ARO Lease, supra* note 68, at Grounds paras. 7, 19-20, 24-27. Liability required a fixed establishment of minimum size with the permanent presence of both human and technical resources. *Id.* para. 15; *Berkholz, supra* note 68, at Grounds para. 18. As noted, the e-products affected by the E-VAT Directive are classified as services. *See supra* notes 51, 53, and accompanying text.

<sup>130</sup>*See* E-VAT Directive, *supra* note 11, at arts. 1(3)(A)(a), (3)(B)(5), (7); *see also* Gnaedinger, *supra* note 66 (comment of Nancy Perks, director of international tax for Microsoft).

<sup>131</sup>*See* E-VAT Directive, *supra* note 11, at art. 1(3)(B)(5) (creating new art. 26c(B)(5) in the Sixth Directive, *supra* note 51) (“The non-established taxable person shall submit . . . a value added tax return. . . . The value added tax return shall set out . . . the total value, less value added tax, of supplies of electronic services for the reporting period and total amount of the corresponding tax.”), (7) (“The non-established taxable person shall pay the value added tax when submitting the return.”).

<sup>132</sup>SCM, *supra* note 20, at art. 1.1(a)(1)(ii) (“1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if: . . . (a)(1)(ii) government revenue that is otherwise due is foregone or not collected” (footnote omitted)).

<sup>133</sup>*See supra* note 34 and accompanying text.

<sup>134</sup>*See supra* note 21.

<sup>135</sup>SCM, *supra* note 20, at art. 1.1(b) (“1.1 For the purpose of that agreement, a subsidy will be deemed to exist if: . . . (b) a benefit is thereby conferred.”).

<sup>136</sup>*See Tax Legislation — United States Tax Legislation (DISC)*, L/4422, BISD 23S/98, Report of the panel adopted 7-8 December 1981, para. 43 (noting the EC’s argument that the territorial tax practices of European countries “were simply methods of avoiding international double taxation” equivalent to the credit method used by the U.S.); *Tax Legislation — Income Tax Practice Maintained By The Netherlands*, L/4425, BISD 23S/137, Report of the panel adopted 7-8 December 1981, para. 17 (“The representative of the Netherlands replied that [the territoriality principle] . . . and the worldwide principle on which the United States’ system was based had been accorded equivalent status internationally.”).

<sup>137</sup>*See supra* text accompanying note 31. The ETI Appellate Body did not contradict the ETI Panel’s reasoning on this point.

<sup>138</sup>With respect to VAT regimes that are primarily destination-based, the input VAT incurred on goods exported from the country of manufacture or processing to the U.S. would likely be creditable against, and refundable if in excess of, output VAT received. *See, e.g.,* Sixth Directive, *supra* note 51, at arts. 15 (exports are exempt from VAT), 17(3), as amended by art. 28f (stating that input VAT is deductible or refundable with respect to transactions that are exempt under art. 15). However, if, for whatever reason, input VAT were not deducted or refunded, it would be creditable. Origin-based VAT would always be creditable because it is not refundable on export. *See* Ebrill et al., *supra* note 12, at 176-177.

<sup>139</sup>The ETI Panel also said that measures sanctioned by footnote 59 do not have to avoid double taxation “entirely, exclusively, or precisely.” *See ETI Panel, supra* note 14, para. 8.95. The ETI Appellate Body decision agreed, saying such measures “are not required to be perfectly tailored to the actual double tax burden.” *ETI Appeal, supra* note 2, para. 146. Those comments are

(Continued on the next page)

## IV. Conclusion

This article is not the first to suggest making VATs creditable on U.S. income taxes. Eighteen years ago, noted scholar Joseph Isenbergh suggested making *all* foreign taxes creditable on the ground that a “properly drawn limitation” on the credit would obviate the need for concern with the “precise methods” a foreign government used in taxing.<sup>140</sup> While the author agrees with that approach in theory, he believes expansion of creditability to VATs alone will help address the problems presented by the ETI repeal and the E-VAT

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(Footnote 139 continued)

not directly applicable here because footnote 59 only applies to export subsidies and, as noted, VAT creditability is not an export subsidy. However, if the panel and appellate body statements are suggestive of the general level of precision required for relief of double taxation, then the fact that neither VATs nor income taxes are always nonshiftable would not bar a measure to relieve the double taxation that occurs when they *are* nonshiftable. Similarly, the fact that their nonshiftable varies dynamically with competition and elasticity of demand and, therefore, may be difficult to predict or track, would not foreclose measures to relieve the double taxation that nonshiftable causes.

<sup>140</sup>Isenbergh, *supra* note 89, at 288. Isenbergh included in his proposal a per-country limitation, per-country recapture of losses, and current taxation of all foreign-source income. *Id.* at 293-295.

Directive without requiring a rethinking of the credit as a whole.

U.S. International Tax Counsel Barbara Angus, in discussing the ETI crisis last November, said that foreign tax credits operate unfairly.<sup>141</sup> With respect to international tax rules in general, she reportedly implored her audience to “[t]hink about where we would want to be if we had the chance to start new!”<sup>142</sup> Considering what we know today about the nonshiftable of both income taxes and VATs, and considering the EU’s unprecedented and unfair extension of VAT liability to U.S. e-tailers, expanding foreign tax creditability to include VATs is a step in the right direction. Not only will it give all American businesses the double taxation relief they deserve, it will go a long way toward erasing the now-outdated distinction between direct and indirect taxes. We have a viable theory of VAT creditability, we have a need for VAT creditability, and we have the political will to bring the two together. All that is left is for Congress to act. ♦

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<sup>141</sup>Gnaedinger, “International Tax Reform,” *supra* note 3.

<sup>142</sup>*Id.*